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Since the signing of the Panama Canal and neutrality treaties, GAO has analyzed issues related to such questions as: will the proposed Panama Canal Commission be financially self-sufficient, what treaty-related costs can be anticipated, and what will be the impact on Canal toll rates. Financial viability of the proposed Commission will depend on treaty-implementing legislation. The legislation should deal with such issues as: the form of organization the proposed Commission should take and who will audit it, assuring an orderly transfer of property and continued efficient operation of functions, resolving Panama's \$8.4 million debt for past services, relating payments for public services to costs and assuring quality of services, how to treat the annual \$10 million contingent payment in financial and toll setting plans, whether the Canal organization should be relieved of its obligation to pay interest on U.S. investments, whether the United States should attempt to recoup its investment through accelerated depreciation charges, the magnitude of other treaty-related costs for personnel terminations and relocation; whether toll revenues will be sufficient to cover costs, and who will bear the burden of increased toll rates. (HTW)

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STATEMENT OF
ELMER B. STAATS
COMPTROLLER GENERAL OF THE UNITED STATES
BEFORE THE
ARMED SERVICES COMMITTEE
UNITED STATES SENATE
ON
THE PANAMA CANAL TREATY

Mr. Clairman and Members of the Committee:

We welcome this opportunity to discuss the financial and operational issues related to the proposed Panama Canal Treaty.

The General Accounting Office, as you know, is responsible for auditing the financial operations of the Panama Canal Company and the Canal Zone Government. We are currently auditing their accounts and financial statements for fiscal year 1976, the transition quarter, and fiscal year 1977.

We have had a long involvement with these entities, dating back to the establishment of the Panama Canal Company in 1951 as a government corporation. Because of our statutory auditing responsibility and long relationship with the Canal Company and Government, we followed the treaty negotiations with great interest. Since the signing of the Panama Canal and neutrality treaties last September, we have been analyzing

the implementation issues involved in the answers to the basic questions which this Committee and others have posed

--will the proposed Panama Canal Commission be financially self-sufficient?

--what treaty-related costs can be anticipated?

--what will be the impact on Canal toll rates?

We are just beginning to see the results of a number of studies which attempt to quantify the treaty implications and which, when considered together, provide tentative answers to these questions. These studies include the Canal Company's estimates of operating costs, revenues, personnel changes and capital requirements; a 5 year projection by Arthur Andersen and Co. of the Canal's financial position; International Research Associates' traffic projections and estimates of commodity sensitivity to various toll increases; and American Management Systems' economic study for this Committee. We have not seen the final results of these important studies, but we will comment today on the preliminary information which we have received. We emphasize that all the cost and revenue figures to which we will refer are preliminary estimates subject to additional refinement.

We believe that the treaty implementing legislation is the key determinant of the financial viability of the proposed Panama Canal Commission. Although this legislative package has not been presented, we will discuss some of the issues which should be considered with this legislation. These issues include

- What form of U.S. government organization should the proposed Panama Canal Commission take?
- Who will audit the new organization?
- What should be done to assure an orderly transfer of property and continued efficient operation of transferred functions?
- How to resolve Panama's \$8.4 million debt for past services?
- What should be done to relate payments to Panama for public services to the actual costs incurred?
- How can the quality of these services be assured?
- How should the annual contingent payment to Panama of up to \$10 million be treated in financial and toll setting plans?
- Should the Canal organization be relieved of its obligation to pay interest on U.S. investment?
- Should the United States attempt to recoup its investment through accelerated depreciation charges?
- What is the magnitude of other treaty related costs for personnel terminations and relocation costs to be borne by the U.S. Government?
- Will toll revenues be sufficient to cover costs?
- Who will bear the burden of increased toll rates?

Form of U.S. Government
Organization and External Audit

The Panama Canal Treaty is silent as to what form of organization the proposed Commission would take--government corporation or independent agency. The Secretary of the Army has recommended to the Senate Foreign

Relations Committee and the House Subcommittee on the Panama Canal that the future Canal Organization continue to be operated under the provisions of the Government Corporation Control Act. Arthur Andersen and Co., financial consultants to the Panama Canal Company, also concluded that a government corporation would be the best form of organization. We agree because it would preserve the businesslike accounting and budgeting principles which have successfully served the Canal Organization for over 25 years.

The distinguishing budgeting, accounting, and auditing features of a government corporation are

- business-type budgets which are submitted for review and approved by the Office of Management and Budget and Congress,
- maintenance of accounting records in accordance with commercial corporate accounting principles and standards, and
- audit by the General Accounting Office with a mandatory report to Congress.

Information required for the business-type budget includes a statement of financial condition, statement of income and expense, analysis of surplus or deficit and statement of source and application of funds.

Our audit of government corporations is on a reimbursable basis and is performed in accordance with the principles and procedures applicable to commercial corporate financial transactions. Unless specifically authorized by law, government corporations cannot engage private accounting firms for audits.

If the proposed Panama Canal Commission is established as a government corporation, we presume that the General Accounting Office will continue to be responsible for the external audit. It is not clear what role, if any, my counterpart, the Comptroller General of the Republic of Panama, would have under the proposed treaty. However, we believe that in line with Panama's greater participation in Canal operations it would be appropriate to explore ways of cooperating with the Comptroller General of Panama concerning the audit.

Transfer of Property and Activities

Article XIII of the treaty provides for the transfer without charge, of assets and activities to the Republic of Panama according to a specified timetable with final transfer upon termination of the treaty. Treaty documentation also provides for the temporary transfer of certain property and activities to the U.S. military forces for operation during the lifetime of the treaty. There has been much discussion about the value of the assets to be transferred and estimates have been given of the replacement values, original costs and book values at the time of transfer. Instead of repeating these estimates today, we would like to call attention to some of the financial aspects and operational problems associated with the transfer which will need resolution.

Section 5(a) of the Annex to the treaty states the Panama Canal Commission and the Government of Panama, or private persons subject to its authority, should consult and "* * * develop appropriate arrangements for the orderly transfer and continued efficient operation or conduct * * *" of the activities and functions. As we understand the provisions of the

Treaty Documents, the United States, has the right to remove equipment, material and supplies from the transferred property, but reason dictates that an orderly transfer and continued efficient operation would require a transfer of some of these items. For example, a transfer of the marine bunkering activities and non-removable assets would necessarily be accompanied by an arrangement transferring adequate materials and supplies to insure continuing operation. The transfer of these current assets is subject to negotiation between the two parties. Similarly, current liabilities, such as accounts payable, and the receivable of \$8.4 million which Panama owes the Canal organization could become negotiation issues.

In broad terms, the steps involved in the transfer process are:

1. A complete inventory and reconciliation with accounting records of all plant, equipment, stocks and materials.
2. Planning for disposal of minor items of equipment and other removable assets, stocks and materials.
3. Negotiation between the transferring parties to insure continuing operations.

As an indication of the effort involved in this process, we would like to point out the last complete physical inventory and valuation of the canal organization's plant and equipment cost about \$750,000 when it was taken in 1950/51 for the establishment of the present organization.

The treaty provides that the Commission will continue to provide certain utility services and would be reimbursed for its costs. There

is no mention in the treaty of Panama's debt for past services which totaled over \$8.4 million at September 30, 1977. We believe that this debt should be settled by either a lump sum payment or as a credit against treaty payments to Panama.

Public Services
Provided by Panama

Article III, Section 5 of the treaty provides that the Commission would pay the Republic of Panama \$10 million a year for the costs involved in providing the following public services in the Canal operating and housing areas: police; fire protection; street maintenance, lighting and cleaning; traffic management and garbage collection.

The Panama Canal Company has estimated that it would cost the Republic of Panama about \$4.4 million to provide the specified public services. If the Commission continued to provide these services, its estimated costs would be approximately \$9.9 million. The difference is attributed to a lower cost of police services, if provided by Panama.

The treaty is not clear as to whether payments for the first 3 years are a flat \$10 million a year or require a determination of the actual costs incurred by the Republic of Panama. After 3 years the treaty appears to relate payments to costs.

"The costs involved in furnishing said services shall be reexamined to determine whether adjustment of the annual payment should be made because of inflation and other relevant factors affecting the cost of such services."

The Department of State has said that an annual \$10 million is reasonable compensation to Panama for the first 3 years of the treaty; but that, thereafter, the payment should be based on Panama's actual costs. The treaty documents, however, are silent on how these costs are to be calculated.

We believe that payments to Panama for public services should be based on the costs incurred and that procedures should be developed to verify these costs, both during the treaty's first 3 years and thereafter.

The treaty also does not contain specific provisions concerning the quality of services to be provided by Panama. The implementing agreement for Article III of the treaty, however, does provide for the establishment of a United States-Panamanian Coordinating Committee for consultation and coordination on matters concerning the housing areas. This committee could possibly serve as a forum for resolution of any problems concerning the quality of public services. We believe that to avoid misunderstanding it is essential to establish standards for these services before they are assumed by Panama.

Contingent \$10 Million Payment

Last November in our testimony before the House Subcommittee on the Panama Canal, we noted the possible ambiguity concerning the treaty-specified payment to Panama of up to \$10 million if operating revenues exceed expenditures. Under one interpretation, if no payments were made during the lifetime of the treaty, a lump sum payment to Panama of over \$200 million could be required at termination of the treaty. The Department of State, however, has said that the proposed Commission is obligated to make this payment only to the extent that operating surpluses exist during the treaty life and that there will be no obligations by either the Commission or the U.S. Government to pay Panama any unpaid cumulative balance after December 31, 1999. Accordingly, the Panama Canal Company has excluded this amount from all its cost projections, including those we used.

To make certain that State's interpretation is clearly understood, we believe that it should be spelled out in implementing legislation. Furthermore, there should be a clear understanding with Panama on the treatment of this obligation, particularly, in view of the treaty language which requires mutual agreement. We also believe that the legislation should include clear language specifying how any operating surplus would be determined.

Interest Payments and
Recovery of U.S. Investment

In our testimony last November, we raised the policy questions of whether the United States should continue to receive interest on its investment and whether the United States should attempt to recoup its investment through accelerated depreciation charges. To illustrate the financial implications of these decisions, we have constructed a condensed statement of Canal operations for fiscal year 1979. This statement, attached to our testimony, is based on the latest Panama Canal Company estimates available to us. Although these estimates are subject to change, they are useful in giving an order of magnitude of the treaty's financial impact and potential revenue deficiencies at current toll rates.

Referring to the first column of the attached statement, you will notice that the proposed Panama Canal Commission would require approximately \$37 million in additional revenues to cover its fiscal year 1979 costs. This estimate includes the assumption that the Commission would be relieved of the statutory obligation to pay interest to the Treasury on the interest-bearing portion of the U.S. investment. This assumption is in

line with Administration's statements that the forthcoming implementing legislative package will relieve the commission of the obligation to pay interest.

If, however, the Commission is not relieved of the interest obligation, the estimated income deficiency would be about \$20 million higher, totaling approximately \$57 million in fiscal year 1979 as shown at the bottom of the second column.

Finally, if a decision was made to recover the U.S. investment in the Canal enterprise, by accelerating depreciation charges on assets retained during the lifetime of the treaty, the income deficiency would increase to about \$79 million shown in column three.

As the attached table illustrates, decisions on interest payments and recovery of U.S. investment have significant implications on the new Canal Organization operation, future toll rates, and U.S. consumers and taxpayers.

Other Treaty-Related Costs

In our discussion today, we have focused on the treaty-related costs for the Panama Canal Commission which would be charged against toll revenues. We would like to point out the possibilities for additional treaty-related costs which might be borne by other U.S. Government agencies. Unfortunately, only sketchy details are available at this time. These costs include

- early optional retirement payments for Canal employees, estimated at about \$8.4 million a year,

- any subsidy for hospital and education services for the estimated 2,100-2,400 employees transferred to the Department of Defense,
- relocation and other costs to DOD, estimated at \$43 million,
- discharging the existing accrued leave liability for employees transferred to Panama and other U.S. agencies.

TRAFFIC AND TOLL PROJECTIONS

Since our last testimony, we have made a preliminary analysis of the revenue-generating potential of tolls and the impact of toll hikes. We would like to discuss our observations on these subjects.

Increased Costs and Tolls

Prior to this decade, sustained traffic growth and efficient management enabled the Panama Canal Company to cover its costs without resorting to toll increases. However, more recently, we have witnessed a slowdown in growth and a rapid increase in costs which led to increased toll rates in 1974 and in 1976. In addition, there has been a change in measurement rules that has raised the effective toll rates.

The current situation is one of continued slow growth in traffic combined with steadily rising costs. As long as this situation persists, there will be continued pressure to raise tolls in order to cover costs. The Treaty provisions for payments to the Republic of Panama from revenue collected by the proposed Panama Canal Commission will add costs and intensify this pressure. An initial rise in tolls will be needed to finance these payments, as well as various transition costs, and later toll increases will likely be needed because of general cost inflation

and the indexing of the 30-cents per ton payment to Panama to the wholesale prices for manufactured goods. While traffic growth in the 1950's and 1960's was great enough to offset inflation without needing to raise tolls, it is prudent to anticipate that toll hikes will be necessary to cover costs throughout the rest of this century, regardless of whether tolls are raised now to provide increased payments to Panama.

Are Further Toll Hikes Feasible?

We, as well as many others, have been concerned with the question of whether it is still possible to increase revenues by raising toll rates, and in particular whether the Commission will be able to raise sufficient additional revenue to fulfill all the payments to Panama called for in the Treaty. The Panama Canal Company and the State Department hired an experienced consulting organization, International Research Associates (IRA), to prepare a study of projected traffic through the Canal, the sensitivity of traffic to toll rate increases, and the maximum revenue potential of the Canal.

So far, we have seen only a preliminary version of that study and are therefore not prepared to comment on its accuracy. Forecasts of Canal traffic are necessarily uncertain, especially beyond 10 years from now. The small toll increases of recent years provide very little statistical evidence for predicting the effects of large toll increases. Uncertainty about future shipments of certain commodities--North Slope oil in particular--adds to the difficulty of forecasting. But if we accept them at face value, the IRA results can be used with estimates of future costs to examine this issue of the potential economic viability of the Panama Canal Commission.

IRA discusses the impact between 1979 and 2000 of toll rate increases assumed to go into effect now. They make the reasonable assumption that a toll rate increase of any given size will lead to a greater diversion of traffic in the long run than in the short. This would happen because in the short run shippers frequently have few alternatives to continued use of the Canal and therefore must pay the higher tolls. As time goes by, more and more alternatives become feasible and some users will switch to these alternatives if it is profitable to do so. IRA estimates that by 1985, all of the diversion likely to occur will have occurred.

As a consequence, IRA's results suggest that it would be very easy to cover costs in the short run by raising tolls; the real test is whether these costs can continue to be covered in the long run as shippers have time to respond. IRA estimates that a 50 percent increase in toll rates will lead to a 33 percent higher revenue total in 1985 compared to the revenue that would be collected in the absence of a toll hike. This amount is estimated at 70 million dollars. Smaller toll rate hikes lead to lower total revenues; for instance, a 40 percent rate increase would generate an estimated 60 million dollars above current revenues. Additional revenue could be obtained by a 75 percent increase in toll rates. Beyond 75 percent, the additional diversion of traffic due to further increases more than offsets the increased revenue per ton on the remaining traffic, so that further increases in total revenue are not obtainable.

It should be pointed out that these estimates of the additional revenues obtainable from toll hikes are based on current prices for

alternatives to the Panama Canal. Broad-based inflation, which would raise the costs of operating the Canal, would also raise the costs of these alternatives. Therefore, it is probable that toll rate increases required to keep up with inflation will be able to be made without causing sufficient diversion such that total revenue would be reduced. That is, future toll rate increases beyond a 75 percent increase should be feasible if these increases are in response to rising costs that affect both the Canal and its alternatives.

Since inflationary cost increases could probably be offset by future toll rate hikes--although with a lag, due to the toll-setting process--the real question is whether the additional revenue that can be made available annually in the long run through an increase in toll rates will be sufficient to cover the additional costs of the Commission that will arise due to the Treaty. According to the Company's preliminary cost estimates which have been used in the attached schedule, a toll rate increase of 40-50 percent should be more than sufficient to enable the Commission to cover its costs, exclusive of interest payments. We hesitate to say that interest payments could also be covered because of the tentative nature of these estimates.

A point worth making in this context is that if a 50 percent toll rate increase, or some other rate, is the rate just sufficient to cover costs in the long run, by 1985, then an immediate toll rate increase of that magnitude will lead to profits in the short run until users of the Canal adjust to the increase. Such short run profits could result in an additional payment to the Republic of Panama. Therefore, it may be

desirable to increase toll rates gradually in order to adhere to the philosophy of charging tolls only sufficient to cover costs. Unfortunately, the IRA study does not analyze the sensitivity of traffic to a two-stage or multi-stage toll rate increase.

Who Would Bear the Cost?

Who would bear the ultimate burden of fulfilling the Treaty obligations to Panama? Since the Treaty calls for Panama to receive benefits from the Canal's existence that it isn't receiving presently, someone or some group would be paying more. U.S. citizens could potentially be affected in two roles: as taxpayers of the country that operates the Canal and guarantees payments to Panama, and as producers and consumers of products shipped through the Canal.

The IRA study suggests that increased toll revenues are obtainable through toll rate increases, so that the burden would fall on the U.S. citizens, as well as citizens of all other countries that use the Canal, in their role, as producers and consumers. Will this burden be large? Almost certainly, no. Most analysis that we have seen suggests that the bulk of any price increase that will derive from a toll rate increase will fall on the importer rather than the exporter of goods shipped through the Canal, although the entire relationship is quite complex since many of the products involved are intermediate goods rather than goods for final consumption. The United States is the destination for approximately 30 percent of the traffic and therefore, U.S. consumers would pay about 30 percent of the higher tolls. In dollar terms, this amount is negligible when compared with our total import bill.

If Canal transits fall short of what is currently estimated, it is possible that toll revenues will be insufficient to cover the costs of the Commission, including the scheduled payments to Panama. In this eventuality, the U.S. Government is likely to be required to provide financial assistance either through congressional appropriations or by allowing the Commission to borrow from the Treasury.

Mr. Chairman, this completes our statement. We would be pleased to respond to any questions you or members of the Committee may have.

FISCAL YEAR 1979:
PANAMA CANAL CONDENSED STATEMENT
OF OPERATIONS UNDER THE 1977 TREATY
 (Based on Panama Canal Company Estimates)

	FY 79 TREATY ESTIMATES		
	EXCLUDING INTEREST <u>1/</u>	INCLUDING INTEREST <u>2/</u>	RETURN U.S. INVESTMENT <u>3/</u>
	----- (millions of dollars) -----		
<u>Operating Expenses Before Payments to the Republic of Panama</u>	220	240	262
<u>Payments to the Republic of Panama:</u>			
Fixed annuity	10	10	10
Public services payment	10	10	10
Annuity based on PC net tons	<u>47</u>	<u>47</u>	<u>47</u>
<u>Total Operating Expenses</u>	287	307	329
<u>Other-Than-Tolls Operating Revenue</u>	<u>63</u>	<u>63</u>	<u>63</u>
<u>NET OPERATING EXPENSES TO BE RECOVERED BY TOLLS</u>	224	244	266
<u>DEFICIENCY, EXCLUDING CAPITAL REQUIREMENTS IN EXCESS OF DEPRECIATION:</u>			
Transition costs	<u>8</u>	<u>8</u>	<u>8</u>
Total to be recovered from tolls in 1979 dollars	232	252	274
Tolls income at existing rates	<u>195</u>	<u>195</u>	<u>195</u>
Net tolls income deficiency	<u><u>37</u></u>	<u><u>57</u></u>	<u><u>79</u></u>
<u>DEFICIENCY, INCLUDING CAPITAL REQUIREMENTS IN EXCESS OF DEPRECIATION:</u>			
Net tolls income deficiency per above	37	57	79
Capital requirements in excess of depreciation (excludes inflation)	<u>*</u>	<u>*</u>	<u>*</u>
Net tolls income deficiency adjusted for capital requirements	<u><u>37</u></u>	<u><u>57</u></u>	<u><u>79</u></u>

* Less than \$1 million.

FOOTNOTES:

- ¹ FY 79 treaty estimates as extracted from the January 1978 Panama Canal Company's preliminary cost estimates to implement the treaty.
- ² Assumes that \$20 million in interest as stated in the draft plan, "STATEMENT OF OPERATIONS," under the column titled "President's Budget 1979" would be paid from tolls income.
- ³ Assumes recovery of U.S. investment in the Panama Canal enterprise. The United States could recover its investment by increasing annual depreciation charges sufficiently above the amounts needed for capital expenditures and raise toll rates to recover this additional depreciation.